IPAMS
Independent Petroleum Association of Mountain States

620 Denver Club Building ◆ 518 17th Street ◆ Denver, Colorado 80202-4167 ◆ 303/623-0987 ◆ FAX: 303/893-0709

November 22, 1996

Mr. David S. Guzy
Minerals Management Service
Royalty Management Program
Rules and Procedures Staff
P.O. Box 25165, MS 3101
Denver, CO 80225-0165

Re: Amendments to Gas Valuation Regulations for Indian Leases, 61 Federal Register 49894, September 23, 1996

Dear Mr. Guzy:

The Independent Petroleum Association of Mountain States ("IPAMS") is a non-profit, non-partisan association representing over 700 independent oil and gas producers, service/supply companies and energy consultants in the Rocky Mountain region. IPAMS submits the following comments to the above-referenced proposed rules.

GENERAL COMMENTS

IPAMS would like to thank the members of the MMS Indian Gas Valuation Negotiated Rulemaking Committee for their hard work, and IPAMS was pleased to have the opportunity to participate in this long and sometimes difficult process. Given the hard work of all those who have participated, IPAMS regrets that it is unable to support the proposed rulemaking.

Process Issues. While IPAMS is not generally opposed to negotiated rulemaking as an approach to problem-solving, the Committee consisted of 19 members, only five of whom reflected an industry perspective, and even fewer of whom were sensitive to small producer concerns. Moreover, given the make-up of the Committee, the voting procedure adopted to establish the so-called "consensus" of the Committee rendered the industry vote, even if voted in concert, essentially meaningless. Other matters of process of particular concern to IPAMS are (1) the belated introduction of the "safety net" requirement which, as discussed in more detail below, undermines the compromise that was reached with respect to the major portion index value and dual accounting formulae, (2) the unilateral decision by the MMS to alter the trade reached with respect to audit closure on major portion calculations outside the index zones, and (3) the eleventh-hour introduction of minimum liquids pricing and the "dual accounting within dual accounting" that will result.

Major Portion Index Formula. The major portion royalty provision existing in many Indian leases is difficult to apply on a current basis, but it is unfair and illegal to apply the provision retroactively years after the fact. While the Secretary is permitted but not required under the typical BIA lease terms to employ the major portion pricing provisions, IPAMS agrees that if the Secretary elects to do so, it should be done in a manner that provides certainty to the small producer on a "real time" basis. Therefore, even though IPAMS expressed concern over the use of index pricing in the federal royalty rulemaking, IPAMS is generally in support of an index-based formula to solve this major portion problem.[1] The formula adopted by the Committee, however, is grossly unfair because it is based on artificially high prices and artificially low transportation costs.

Much discussion was had within the Committee regarding the meaning of the phrase "highest price paid or offered . . . for the major portion [of gas] . . . produced and sold from the field." This phrase does not require or permit using the highest price in the field, but rather the price at which the majority of the gas was sold in the field. Nonetheless, the proposed formula utilizes the highest index price -- a price that clearly does not give meaningful effect to the phrase "major portion". The unfairness of the formula is further compounded by its inadequate accounting for the small producer's transportation costs. By starting with an artificially high price and deducting artificially low transportation, the compounding effect of the formula creates undue hardship for the small producer and greatly increases the costs of doing business on Indian lands.

Additional Concerns. IPAMS is deeply distressed by the overall hostility displayed toward the small producer in both the process and the outcome of this rulemaking process. The "major portion" clause as written in the leases is an unworkable clause. Even if everyone had agreed in the past on what it means, the producer doesn't have the information he needs to calculate major portion and the MMS apparently doesn't have the manpower it needs to make the calculation for

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[1]The best solution to the unworkability of the major portion clause is for the Secretary to decline to exercise his discretion to invoke it in the first place.

every field for every month on anything close to a real-time basis. It must be remembered, however, that the small producer is not the author of this unworkable clause and is not to blame for its impracticality. Nonetheless, it is primarily the small producer who will pay the price under these proposed regulations. The proposed regulation will clearly have the greatest impact in those producers (*i.e.*, small producers) whose comparatively low bargaining power will generally translate into lower prices and higher transportation costs than realized by the majors and large independents. Similarly, it will be the small producer whose sales at the wellhead or whose higher processing costs will make it financially impossible to use the alternative dual accounting method. It will therefore be the small producer who will be forced to deal with the onerous "dual accounting within dual accounting" that will result from the new minimum NGL pricing provisions and the small producer who will be forced to deal with the difficulties of "actual" dual accounting for wellhead sales.

1988 Regulations. In the spirit of the Committee's recommendations, IPAMS has refrained from making substantive comments on that portion of the proposed regulations that are mere carry-forwards of the 1988 regulations. This should not be interpreted as IPAMS's agreement with those regulations or with any of MMS's various interpretations or applications of those regulations.

COMMENTS TO THE PREAMBLE

IPAMS has the following comments to the Preamble, many of which, of course, will apply to specific regulations.

> MMS states in the Preamble that many of the provisions of the proposed rules are the same as existing rules in substance, but rewritten for purposes of clarity (49895). The Preamble should include a clear statement from the MMS that its "plain English" revisions are not intended to change the substance of any of the regulations. Use of the word "you" and "your" in the plain English dialect is particularly dangerous because of its potential to influence interpretation of the regulations with respect to payor/lessee/operator liability issues and with respect to the affiliate proceeds issue. It would be inappropriate for the MMS to use the guise of "plain English" to gain advantage in the ongoing disputes regarding these issues.
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> The MMS states that it removed the definition of "marketing affiliate" from the proposed regulations because it is no

longer relevant to valuation in today's market (49896). IPAMS disagrees. This matter was never discussed by the Committee and to the extent it is intended by the MMS to bolster its arguments on the affiliate proceeds issue, it is highly objectionable and an affront to the negotiated rulemaking process.

IPAMS questions whether the establishment of the entire Rocky Mountain area as a single zone satisfies the criteria set forth in Section 206.172(d) (49896). To be valid under the lease terms, a zone must be reflective of the market in the field or area in which the lease is located. Local, not regional, markets are operative.

The MMS makes reference to gas contract settlements in the Preamble (49896). It must be emphasized that the Committee agreed to disagree on this issue and recommended that the proposed regulations not be used to benefit one side of the argument or the other. This is not the tone of the MMS's comments and, for all the reasons given by IPAA and by the court in the case of IPAA v. Babbitt, IPAMS disagrees that the valuation procedures in effect since 1988 require payment of royalties on gas contract settlement proceeds.

The Committee agreed that gas would not be subject to dual accounting if it flows into a mainline prior to processing (49896). The unilateral change of this provision by the MMS from mainline to "pipeline with an index" was not authorized by the Committee and, in fact, contradicts the Committee recommendation. IPAMS objects to this unilateral alteration by the MMS.

The discussion by the MMS in the Preamble regarding the "safety net" (49897) is misleading for several reasons. First, industry's objection to the safety net was not just an objection to tracing gas sales, but also an objection to the process. The compromise underlying the major portion index formula was possible only because certain industry representatives were persuaded that the simplicity and real-time certainty of the formula and the promise of no longer having to deal with the MMS's nebulous and ever-changing interpretations of "gross proceeds" would be worth some increase in royalty. Forcing the safety net into the equation many months after this compromise was reached, however, significantly undermined the premise on which industry agreed to the formula in the first place. Second, the Preamble states that the purpose of the safety net is to test the validity of the index (49897). This is not true. The safety net was injected into the process solely to capture downstream value in markets far beyond the field or area in which the lease is located. IPAMS believes that chasing downstream value under the guise of major portion is inconsistent with the lease terms, which clearly contemplate valuation based on a local market.

If a fair major portion formula had been proposed (which is not the case), IPAMS would support the creation of an alternative to dual accounting of the sort crafted by the Committee. IPAMS believes, however, that the empirical basis for the percentage "uplifts" is weak and unreliable, being based, as it is, on the experience of a single major producer in a limited geographic area for a limited time period (49898).

With regard to calculation of major portion outside a valid index zone, the MMS states that "[t]he Committee agreed that the price at which 25% or more of the gas is sold is a reasonable compromise on the term *major*" (49899). This is inaccurate. In reaching this compromise, the industry representatives never agreed that 25% is reasonable; only that it was an acceptable trade in exchange for audit closure. The MMS has reneged, however, and has removed the very basis for industry's compromise by limiting the closure provisions to the states of Montana and North Dakota. Similar to the safety net situation, the purported benefits to industry on which the original compromise was based have been withdrawn (49899).

As discussed in more detail below, IPAMS strongly objects to establishing a minimum value for NGL's (49899), and particularly objects to a net back valuation that begins with a market that is outside the field or area.

The MMS states, "Generally, if any gas production for a month is subject to dual accounting, that value sets the minimum value for all lease production for that month" (49900). This statement and the rest of the paragraph in which it appears is inaccurate and confusing. The earlier description of these matters in connection with the discussion of Section 206.173 is more accurate and much easier to understand.

The Preamble states that transportation allowances will continue to be limited to 50% of "proceeds." This is not correct. The regulations refer to "value" and not proceeds. Value will almost always be greater than proceeds after applying the major portion and dual accounting provisions of the regulations.

Regulatory Flexibility Act -- it is inaccurate to say that the proposed rules will not have a significant economic effect on a substantial number of small entities. To the contrary, the regulations will result in a significant increase in Indian royalty obligations and, consequently, will have a substantial adverse economic affect on every producer who operates on Indian lands. The effects will be particularly devastating for small producers. Moreover, the impact on small producers is measured not only by the increase in economic burden between the 1988 regulations and the proposed regulation, but also by the increase in economic burden caused by the Secretary's decision to exercise his discretion to apply the major portion provision of the lease. Historically this discretion has not been exercised.

COMMENTS TO PROPOSED REGULATIONS

A. Section 202.550--How to Determine the Royalty Due on Gas Production.

§ 202.550(b) and (c). IPAMS incorporates its comments to the Federal Negotiated Rulemaking with respect to the burden created by requiring small producers to pay royalty on volumes greater than their "takes."

§ 202.550(d). Transportation field fuel and reinjected unprocessed gas, gas plant products and residue should also be listed as gas not subject to royalty.

B. Section 206.171 - Definitions.

In the definition of "Posted Price" it is unnecessary and misleading to refer to marketable condition. If the price is a publicly available bulletin price, the gas to which it applies is, by definition, gas in marketable condition.

C. Section 206.172 - How to Value Gas Produced from Leases in an Index Zone.

§ 206.172(b)(1)(ii). This paragraph should be modified to refer to gas that is not processed before it flows into a main line and should not be limited to pipelines with an index point. Parallel changes should also be made to the title and text of paragraph (c).

§ 206.172(b)(2)(ii). The Committee agreed to disagree on the issue of gas contract settlements, but it did recommend that if contract settlement proceeds were ultimately determined to be royalty bearing, any incremental value due under the May 3, 1993, Dear Payor Letter would be added to gross proceeds, not to the value as increased by major portion or dual accounting. Consequently, this section needs to be expanded to include increased value from dual accounting. Also, comparison to gross proceeds should not be required for any time period after expiration of the term of the contract that was settled.

§ 206.172(c)(1) and (2). These subparagraphs should make it clear that both processing and transportation allowances are used in dual accounting. Also, the reference in subparagraph (iii) to Subpart B should be replaced with a specific cross reference that does not require the reader to review an entire subpart and guess which particular provision the cross reference was intended to identify.

§ 206.172(d). Somewhere in this section it should be stated clearly that payment based on index value subject to the safety net fully satisfies the "major portion" and "amount realized" provisions of the lease.

§ 206.172(e). As stated previously, IPAMS believes the safety net violates the compromise struck in support of the major portion formula, and while IPAMS believes the accounting and other benefits to be derived by industry from that compromise are not worth the inflated royalty values that will result, this provision essentially takes away even those inadequate benefits. IPAMS also believes that any attempt, in any context, to base royalty values on downstream sales is illegitimate.

D. Section 206.173 - Alternative Methodology for Dual Accounting.

§ 206.173(a)(2)(iii). This subparagraph is grammatically incorrect and should be revised to read, "When you elect to use the alternative methodology for a designated area, you must also use the alternative methodology for any new wells commenced and any new leases acquired in the designated area during the term of the election."

§ 206.173(b)(4). In subparagraph (i) it states that you must use the alternative method, whereas in subparagraph (ii) it states that you may use the alternative method. The language should be conformed, and IPAMS believes the word "may" is more appropriate because the alternative methodology is an election and not a requirement.

E. Section 206.174 - How to Value Gas Production When an Index Space Method Cannot be Used.

§ 206.174(a)(1). The second sentence of this paragraph is grammatically incorrect and implies that the valuation of gas plant products is governed by this section, regardless of whether those products have a Btu value. This sentence should be corrected to read, "It also applies to the valuation of gas from all Indian leases that is sold under a dedicated contract, and to the valuation of gas plant products and components of the gas stream that have no Btu value (for example, . . .)."

§ 206.174(a)(4)(ii). This paragraph should be amended to clarify that the values to be used in the array are after deduction of allowances.

§ 206.174(g)(2). In addition to the process issues discussed above, this paragraph is objectionable for the following reasons:

- It ignores the express major portion lease language that refers to the field or area and looks instead to markets downstream of the lease hundreds, if not thousands, of miles away.

- It is based on the erroneous assumption that the lessor is entitled to trace its royalty into the downstream markets and that the lessee has a duty to by-pass markets in the field or area in favor of those downstream markets.

- It appears not to permit any allowances for processing or transportation upstream of the plant tailgate.

- It creates dual accounting within dual accounting and further penalizes those who choose not to elect the alternative methodology for dual accounting.

- It reflects an unprincipled "net back" methodology that the MMS has already characterized as the least desirable methodology. There is no principled basis to require the lessee to bypass existing local markets in favor of downstream markets. Next, the MMS will want to reach past Belvieu and Conway all the way to the point of ultimate consumption.

§ 206.174(j). There should be a cross-reference in this paragraph to ensure that it does not undercut the provisions of § 206.174(l).

§ 206.174(l)(1). As stated previously, limiting the audit closure provisions to Montana and North Dakota does violence to the compromise reached by the Committee. In addition, the second sentence of this paragraph requiring lessees to "confess" to possible underpayments was not part of the compromise, undermines the closure that was the objective of the compromise, and should be deleted. A "confession" requirement is not only offensive, it places an impossible burden on the lessee given the broad range of significant differences of legal opinion between lessees and lessors in this arena and in light of the lessons learned from MMS's own ever "evolving" and ever more aggressive interpretations of the 1988 regulations. The lessee must not be required to anticipate every legal position the MMS may take, regardless of how extreme, and adjust royalties accordingly. Moreover, such a significant change in basic royalty procedure and philosophy should not be tucked away in an obscure provision of a proposed rule purporting to deal with mundane accounting matters. IPAMS also notes that there is no provision putting a reciprocal obligation on the MMS and its delegees to report any adjustment that would result, under any industry legal theory, in a reduction of royalties owed.

§ 206.174(l)(1)(ii). To conform to parallel language in paragraph (l)(1)(i), the closing language of the last sentence should be amended to read, "after the last day of the 12th month following the last day to report adjustments."

§ 206.174(l)(2)(i). Amend the opening phrase of this paragraph to read, "If you have a pending dispute with your purchaser that affects valuation. . .." Disputes on other matters should not be used by the MMS to avoid the audit closure provided in this section. Also, there is no mechanism for how this and similar extensions are initiated. They should not be self-executing, but require some notice by the lessee of the existence of the pending dispute. Otherwise, the MMS may try to use this provision years after the fact to avoid audit closure.

§ 206.174(l)(2)(ii). Amend the opening phrase of this paragraph to read, "If you have a pending dispute that affects valuation with the person transporting. . .."

§ 206.174(l)(2)(iii). This provision should be modified to read, "If there is a written agreement between you and MMS or its delegee to extend the time limit, the time period is extended . . .." Other agreements are irrelevant and must not be used by the MMS to avoid closure.

§ 206.174(l)(2)(iv). This subparagraph should be revised to clarify what is meant by "final resolution" of a pending regulatory proceeding. For example, if an appellant does not seek judicial review, is final resolution measured from the date of the final agency decision or from the date on which the time to seek judicial review expired?

F. Section 206.176 - How to do Accounting for Comparison.

§ 206.176(c). See previous comments regarding the improper requirement that the pipeline be located in an index zone.

§ 206.176(e). There is no need to compute the weighted average Btu when the alternative method is not being used. This paragraph need only state that you do not have to perform dual accounting for an FMP with a Btu content of less than 1000. Likewise, the cross-reference to § 206.173 is not necessary.

G. Section 206.178 - How to Determine a Transportation Allowance.

§ 206.178(a). The lead-in language to this paragraph should be consistent with the lead-in language in paragraph (b) and state that this paragraph, applies where you have an arm's-length transportation agreement.

General Comment. The alternative that appears in 206.157(b)(5) of the 1988 regulations relating to tariffs has not been carried forward. No mention of this omission is made in the Preamble, nor did the Committee agree to the omission. This alternative should be preserved in the proposed regulations.

§ 206.178(f). The first sentence of this paragraph should conform to similar language in 206.174(e) and specify that "you are required to report and pay additional royalties on the difference, plus interest computed . . . ."

§ 206.178(g). The 1988 regulations contain an exception for FERC or state approved tariffs. This exception has been omitted without explanation in the Preamble and without agreement by the Committee and should be reinstated.

H. Section 206.179 - General Provisions Regarding Processing Allowances.

§ 206.179(f). This paragraph is out of place. It should be moved to Section 220.550(d) and should include unprocessed gas as well as residue gas and gas plant products.

Additional and Extraordinary Allowances. The provisions in the 1988 regulations covering additional and extraordinary transportation and processing allowances have not been carried forward into the proposed regulation. This was done without agreement by the Committee and IPAMS objects.

I. General Comments Regarding Drafting.

The drafters of the regulations are inconsistent in their use of the phrase "less applicable allowances" and the phrase "including applicable allowances." Compare, *e.g.*, § 206.174(a)(2) with § 206.176(a).

There is also an inconsistency throughout the proposed regulations in the use of the phrase "gas, residue gas, or any gas plant product" as used in the first sentence of paragraph 206.174(b)(1)(i) and the phrase "*unprocessed* gas, residue gas, or plant products" as used in § 206.177(a). The phrase that incorporates the word "unprocessed" is more precise and avoids the implication that "gas" is a narrow term that does not include residue gas or gas plant products.

In conclusion, IPAMS cannot support the proposed rule as drafted. For the reasons stated above, IPAMS believes that the proposed rule will create undue hardship for the small producer and greatly increase the costs of doing busines on Indian lands. IPAMS appreciates the opportunity to comment.

Very truly yours,

Barbara L. Widick
Director of Regulatory Affairs

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